September 22, 2006

MEMORANDUM

TO: Legislative Finance Committee Members

FROM: Norton Francis, LFC Chief Economist and Michelle Aubel, LFC Fiscal Analyst
Robert Cardon, DFA Budget Analyst

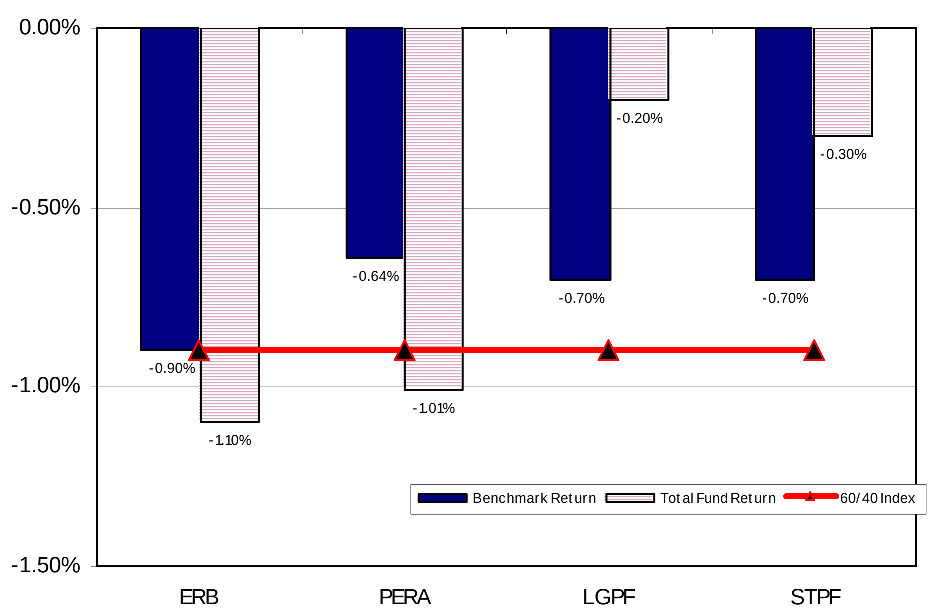
SUBJECT: Joint Report of Investment Performance – FY2006 Fourth Quarter & Annual Report.

This is a joint report by the LFC and DFA investment oversight staff, per the Accountability in Government Act.

SUMMARY OF FUND PERFORMANCE

Quarter Ending June 30, 2006. The New Mexico investment funds gave back returns in the fourth quarter but still managed to finish FY06 in positive territory. As shown in Figure 1, the Educational Retirement Board (ERB) had the largest quarterly loss with a return of -1.1 percent, followed by the Public Employees Retirement Association (PERA), which lost 1 percent. Both the Severance Tax Permanent Fund (STPF) and the Land Grant the Permanent Fund (LGPF) returned -0.3 percent and -0.2 percent respectfully in the fourth quarter. The STPF and the LGPF are managed by the State Investment Council (SIC) but have different investment policies.

Figure 1
New Mexico Investment Agency Returns, Quarter Ending June 30, 2006

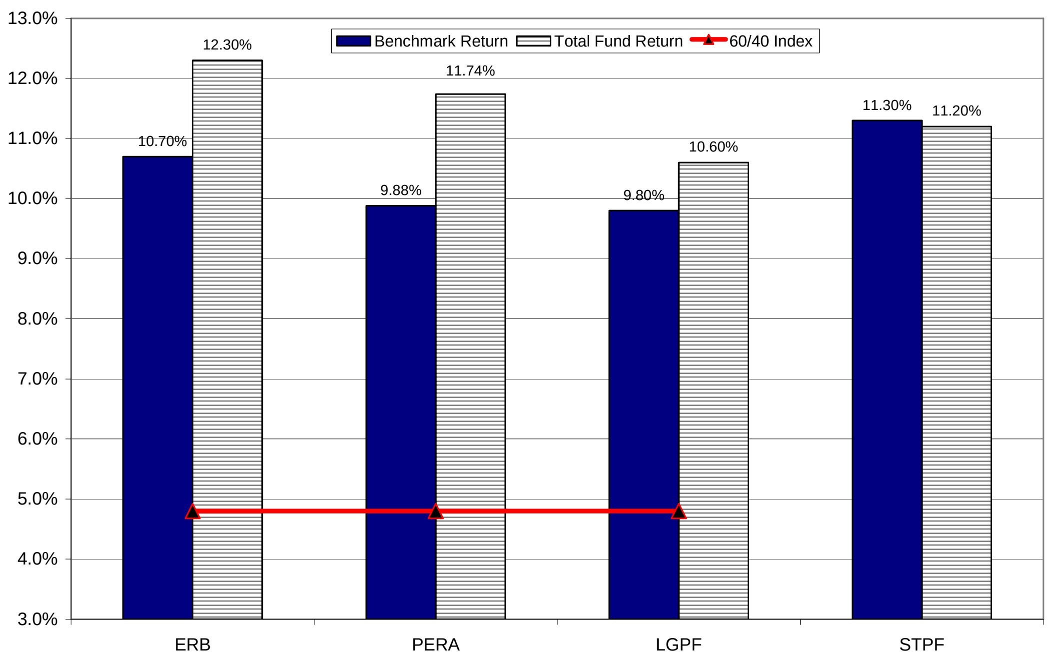


Each fund's investment performance is compared to a fund benchmark return referred to as the fund's Internal Policy Target. Note that the each fund's internal policy target return is different because they are comprised of a blend of market indices that best match up with their own unique investments. This quarter, both ERB and PERA missed their internal policy target while the LGPF and STPF outperformed their internal policy targets as displayed on Figure 1.

Since each investment agency has an actively managed portfolio, there is an expectation that their investment returns over the long-term should be higher than the return of a balanced portfolio of stocks and bonds invested in low cost index funds that represent the entire market (Passive Management). For comparison purposes, the measure is comprised of 60 percent domestic stocks, as measured by the Standard and Poor's 500, and 40 percent domestic bonds (60/40), as measured by the Lehman Brothers Aggregate. The 60/40 target for the quarter was -0.9 percent which was only surpassed by the SIC's funds.

Year Ending June 30, 2006. In the one-year period ending June 30, 2006, investment returns finished positive, despite giving up gains to a disappointing fourth quarter. ERB posted the highest return at 12.3 percent, followed by PERA, at 11.74 percent; both funds beat their one-year benchmarks by 1.6 percent and 1.9 percent respectfully. The STPF gained 11.2 percent for the year but trailed its policy target by 0.1 percent while the LGPF returned 10.6 percent, beating its policy target by 0.8 percent.

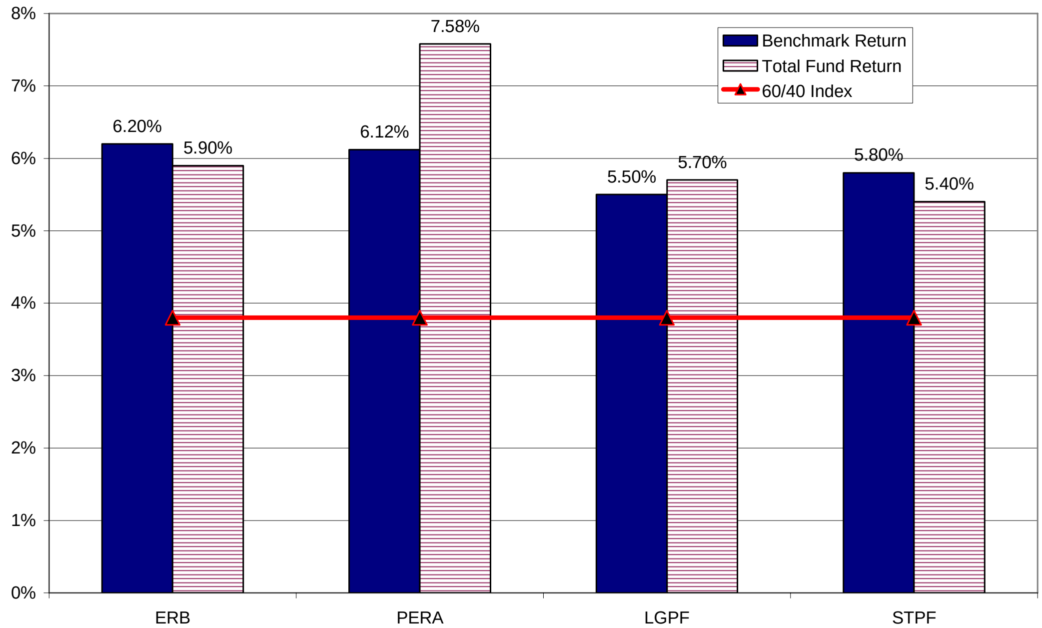
Figure 2
New Mexico Investment Agency Returns, One Year Ending June 30, 2006



Five Years Ending March 31, 2005. For the five years ending June 30, 2006, PERA led with the highest return at 7.58 percent, which beat its fund benchmark return of 6.12 percent by an impressive 1.5 percent. ERB had the next highest return at 5.9 percent, but missed its target by 0.3 percent. The LGPF's return of 5.7 percent outperformed its target of 5.5 percent by 0.2

percent and the STPF finished at 5.4 percent missing its target by 0.4 percent. All the investment funds surpassed the five year 60/40 index, which returned 3.8 percent.

Figure 3
New Mexico Investment Agency Returns, Five Years Ending June 30, 2006



FUND ASSET VALUES

Table 1 presents the ending asset values of each fund as of June 30, 2006. The changes in the quarterly and annual asset values in the table reflect both contributions and disbursements to each of these funds in addition to investment returns. The total value of all the funds on June 30, 2006, was $32.6 billion, down slightly by approximately $300 million from the March 31, total fund value of $32.9 billion. Overall, for the year ending June 30, 2006, the value of all funds totaled $3 billion from last June's total value of $29.6 billion.

Table 1
Current Asset Values ($millions)
For Quarter and Year Ending June 30, 2006

Quarterly	**ERB**	**PERA**	**LGPF**	**STPF**
Current Asset Values (06/30/06)	8,166.3	11,311.2	9,099.0	4,015.1
Value Change (Previous Quarter)	(122.0)	(144.0)	(26.0)	(56.2)
Percent Change	-1.5%	-1.3%	-0.3%	-1.4%

Annual	**ERB**	**PERA**	**LGPF**	**STPF**
Ending Asset Values (6/30/05)	7,404.2	10,198.3	8,251.1	3,768.8
Value Change (Year Ago)	762.1	1,112.9	847.9	246.3
Percent Change	10.3%	10.9%	10.3%	6.5%

ECONOMIC AND FINANCIAL MARKET ENVIRONMENT

The quarter ended with a sharp slow down. GDP, which measures the value of all goods and services produced in the United States rose at only 2.9 percent annual rate in the fourth quarter, a sharp drop from the rapid 5.6 percent pace of the previous quarter. The GDP growth is expected to be capped below 3 percent for the next year as consumers are becoming cautious with the downturn in housing and the higher cost of oil and gasoline. The price of oil remained at $70 a barrel and gasoline cost averaged over $3 a gallon fanning fear of rising inflation. Troubling to many economists were signs that businesses are passing their energy costs on to consumers and are finding it easier to raise prices. The Federal Reserve is still expected by many economists to raise rates in 2006 at least one more time despite the worry of over-tightening and sending the housing market into a tailspin.

Stocks retreated in the quarter with the news of a slowing housing market and the possibility of more rate hikes by the Federal Reserve. The Standard & Poor's 500, which is composed of value stocks, fell -1.4 percent during the quarter to end at 1,270. The Dow Jones closed the quarter at 11,150 slightly higher than last quarter by 41 points and the NASDAQ saw the largest decline of over 7.7 percent from 2,339 to 2,172 to end the quarter. International markets which lead returns previously, also cooled to less than 1 percent growth compared to the previous quarter of 9.4 percent, as measured by the MSCI EAF index, an index of developed countries.

The fixed income markets continue to fall while there are no signs that interest rates will stop rising.

ASSET ALLOCATION

All funds continue to be overweighed in equities and underweighted in fixed income securities, which have advanced fund returns because equity continues to outperform fixed income investments. All of the funds also were over weighted in international equity, which experienced the largest down turn in the last quarter. Despite the losses in the quarter, emerging markets have outperformed all other sectors in the last five years, boosting returns to the funds by more than double of the lackluster domestic market.

The SIC funds have significantly moved toward their target allocations in the alternative investments, particularly hedge funds. Both the STPF and the LGPF are now at their targets of 10 percent. The LGPF is near its target for private equity while the STPF is still below target.

Due to the fixed income reallocation in process, the cash equivalents for the PERA fund were much higher than the target. PERA is also holding an amount from $50-75 million to cover excess distributions over contributions for FY07.

	ERB		PERA		STPF		LGPF	
	Actual	**Target**	**Actual**	**Target**	**Actual**	**Target**	**Actual**	**Target**
US Equity	46.1%	46.0%	41.3%	40.0%	49.4%	53.0%	51.1%	53.0%
Large Cap US Equity	39.7%		30.7%	30.0%	37.8%	42.0%	39.3%	42.0%
Mid/Small Cap. US Equity	6.4%		10.6%	10.0%	11.6%	11.0%	11.8%	11.0%
REIT	5.2%	5.0%						
Total US Equity	**51.3%**	**51.0%**	**41.3%**	**40.0%**	**49.4%**	**53.0%**	**51.1%**	**53.0%**
International Equity	**22.2%**	**20.0%**	**26.4%**	**25.0%**	**11.1%**	**10.0%**	**10.1%**	**10.0%**
Fixed Income								
U.S. Fixed Income (Core)	20.3%	24.0%	28.5%	33.3%	9.6%	8.0%	17.6%	15.0%
U.S. High Yield Bonds	5.0%	5.0%	1.6%	1.8%	2.8%	3.0%	2.6%	3.0%
TIPS		0.0%						
ETI's*		N/A	N/A	N/A	4.4%	1.0%	0.0%	
CDO					1.6%	0.0%	1.7%	
Total Fixed Income	**25.3%**	**29.0%**	**29.8%**	**35.0%**	**18.4%**	**12.0%**	**21.9%**	**18.0%**
Private Equity**		N/A	N/A	N/A	7.9%	12.0%	5.2%	6.0%
Hedge Funds					9.9%	10.0%	10.2%	10.0%
Real Estate		N/A	N/A	N/A	2.0%	3.0%	1.1%	3.0%
Cash Equivalents	1.1%	0.0%	2.0%	0.0%	1.1%	0.0%	0.5%	0.0%
Total Fund %	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

** ETI stands for economically targeted investments*
*** Performance for Venture Capital is reported on a 3 to 4-month lag*

ADDITIONAL DETAIL ON FUND PERFORMANCE FOR QUARTER

Table 3 below shows detailed fund performance for the quarter ending June 30, 2006. For comparison purposes, the table also provides the return for market benchmarks that the investment agencies agreed to in September 2002 (note, these benchmarks are distinct from the individual fund benchmark returns, which are also included in the table).

Table 3
Fund Performance Detail

Asset Class	Benchmark**	ERB	PERA	LGPF	STPF
U.S. Equity (Russell 3000)	*-2.0%*	-2.2%	-1.9%	-1.9%	-1.9%
U.S. Equity (Wilshire 5000 Cap Wtd)	*-2.0%*	-2.2%	-1.9%	-1.9%	-1.9%
Real Estate Investment Trusts (REITS) (DJ Wilshire REIT)	*-1.1%*	-1.2%	n.a.	n.a.	n.a.
U.S. Fixed Income (LB Aggregate)	*-0.1%*	0.0%	-0.1%	0.7%	0.7%
U.S. High Yield Bonds (ML HY)	*-0.2%*	-0.8%	-0.8%	-0.8%	-0.8%
U.S. High Yield Bonds (Citi HY Cash Pay)	*0.0%*	0.3%	-0.8%	-0.8%	-0.8%
International Equity (MSCI EAFE)	*0.7%*	-0.5%	-1.0%	-2.6%	-2.6%
Emerging Markets Equity (MSCI EMF)	*-4.3%*	-5.5%	-5.6%	-5.7%	-5.7%
Private Equity/Venture Capital (Cambridge	3.8%	n.a.	n.a	17.4%	8.7%

Table 3
Fund Performance Detail

Asset Class	Benchmark**	ERB	PERA	LGPF	STPF
Venture Capital)*					
Economically Targeted Investments (90 day T-bill)	*1.2%*	n.a.	n.a	1.0%	1.0%
Real Estate (NCREIF)	*4.0%*	n.a.	n.a	5.6%	10.1%
Hedge Funds (90 day T-bill + 200 basis points)	*1.7%*	n.a.	n.a	2.0%	2.0%
Individual Fund Policy Target		-0.9%	-0.1%	-0.7%	-0.7%
Total Fund Return		**-1.1%**	**1.0%**	**-0.2%**	**-0.3%**

** Performance for Venture Capital is reported on a 3 to 4-month lag*
*** Benchmarks are for comparison purposes and do not correlate to the individual fund's policy targets.*

<u>Quarterly Management Performance</u>

The fund performance compared with the internal targets is made up of two components: management performance (manager effect) and asset allocation. The manager effect is a measure of how the individual manager's performance compared to the performance of the benchmark and the asset allocation effect is the impact of a portfolio allocation being different from the target allocation. In general, assuming the fund is following a disciplined rebalancing program, the asset allocation effects should be close to zero. The manager effect should be larger, reflecting the added value of using a managed approach rather than a passive, or index only, approach. Returns reported are not net of management fees.

Quarterly Performance

- For the quarter, ERB posted a -1.1 percent return trailing its policy index by 20 basis points. The manager impact on the fund was less than -20 basis points.

- PERA returned 1.01 percent missing its policy target by 37 basis points. The manager impact was -40 basis points.

- The LGPF and STPF returned -0.2 percent and -0.3 percent, respectively, which outperformed the fund benchmark returns of -0.7 for both funds. The LGPF manager performance added 60 basis points in enhanced returns while allocation impacts reduced returns by 10 basis points. The STPF performance was driven by the manager impact adding 44 basis points in return while the allocation impact was a minor drag at -3 basis points.

ADDITIONAL DETAIL ON ANNUAL FUND PERFORMANCE

Table 4 below shows detailed fund performance for the fiscal year ending June 30, 2006. For comparison purposes, the table also provides the return for market benchmarks that the investment agencies agreed to in September 2002 (note, these benchmarks are distinct from the individual fund benchmark returns, which are also included in the table).

Table 4
Fund Performance Detail FY6

Asset Class	**Benchmark****	**ERB**	**PERA**	**LGPF**	**STPF**
U.S. Equity (Russell 3000)	*9.6%*	10.2%	11.0%	11.3%	11.3%
U.S. Equity (Wilshire 5000 Cap Wtd)	*9.9%*	10.2%	11.0%	11.3%	11.3%
U.S. Large Cap (S&P 500 Index Fund)	*8.6%*	9.3%	9.5%	8.4%	8.4%
U.S. Small Cap (Russell 2000)	*14.6%*	15.3%	15.3%	11.6%	11.6%
Real Estate Investment Trusts (REITS) (DJ Wilshire REIT)	*22.0%*	21.9%	n.a.	n.a.	n.a.
U.S. Fixed Income (LB Aggregate)	*-0.8%*	0.7%	0.0%	1.8%	1.8%
U.S. High Yield Bonds (ML HY)	*4.5%*	6.0%	3.2%	3.6%	3.6%
U.S. High Yield Bonds (Citi HY Cash Pay)	*3.9%*	6.0%	3.2%	3.6%	3.6%
U.S. High Yield Bonds (LB High Yield)	*4.8%*	6.0%	3.2%	3.6%	3.6%
International Equity (MSCI EAFE)	*26.6%*	29.1%	30.3%	20.8%	20.8%
Emerging Markets Equity (MSCI EMF)	*35.9%*	34.1%	34.0%	35.1%	35.1%
Private Equity/Venture Capital (Cambridge Venture Capital)*	13.7%	n.a.	n.a	21.8%	14.3%
Economically Targeted Investments (90 day T-bill)	*4.0%*	n.a.	n.a	7.0%	7.0%
Real Estate (NCREIF)	*18.2%*	n.a.	n.a	6.8%	10.6%
Individual Fund Policy Target		10.7%	9.9%	9.8%	11.3%
Total Fund Return		**12.3%**	**11.7%**	**10.6%**	**11.2%**

** Performance for Venture Capital is reported on a 3 to 4-month lag*
*** Benchmarks are for comparison purposes and do not correlate to the individual fund's policy targets.*

Annual Performance

- ERB ended its year with an annual return of 12.3%, 160 basis points over the target of 10.7%, and ranking in the 10th percentile of public funds. The manager impact added about 1% of the excess gain and the allocation contributed about .5%.

- PERA beat its benchmark by 186 basis points, earning 11.74% for the year. The manager effect accounted for 151 basis points, while the asset allocation added an additional 18 basis points.

- The LGPF and STPF returned 10.6 percent and 11.2 percent, respectively. The LGPF surpassed its benchmark by 80 basis points., 100 due to manager impact and -20 due to allocation impact. The STPF missed its benchmark by 10 basis points; the manager impact, a positive 25 basis points, was countered by an allocation impact of -34 basis points.

CURRENT ISSUES

In 2006, the Legislature appropriated $40 million to the Water Trust Fund., which will now be managed by the State Investment Council. Also, being released on October 9 is the film “Employee of the Month,” which stars Jessica Simpson. SIC invested in this film and believes it will do well at the box office.

Eclipse Aviation, in which the SIC is an investor, received certification in July. This will result in a re-valuation of the company, which is expected to boost the SIC’s total internal rate of return (IRR) for its private equity investments. On the down side, the SIC had one failure in its private equity. TCI Medical closed down due to overwhelming competition from GE, which recently entered their market. The SIC had $7 million invested in TCI.

ERB is seeking a commission recapture broker which will allow ERB to receive discounted trades. SIC and PERA already have this program in place.

ERB’s and PERA’s entry in Alternative Investments is progressing, as detailed at the August LFC hearing. ERB has finalized its five hedge fund manager and plans on being fully invested in this asset class by the end of December. PERA is anticipating making its first foray into alternatives, with its alternative manager, Cliffwater, bringing two direct fund opportunities before the Board in September at a special meeting. Both entities have updated their Procurement Policies to allow greater flexibility to contract with fund managers.