State of New Mexico
LEGISLATIVE FINANCE COMMITTEE

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April 7, 2015

LFC INVESTMENT REPORT FOR THE QUARTER ENDING DECEMBER 31, 2014

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 these agencies differed from that of the archetypical fund and how management and consultants added or subtracted value. This report includes fund returns and comparative rankings for the one, three, five, and ten-year periods and attribution analysis for the quarter, one, and three-year periods.

Market Environment

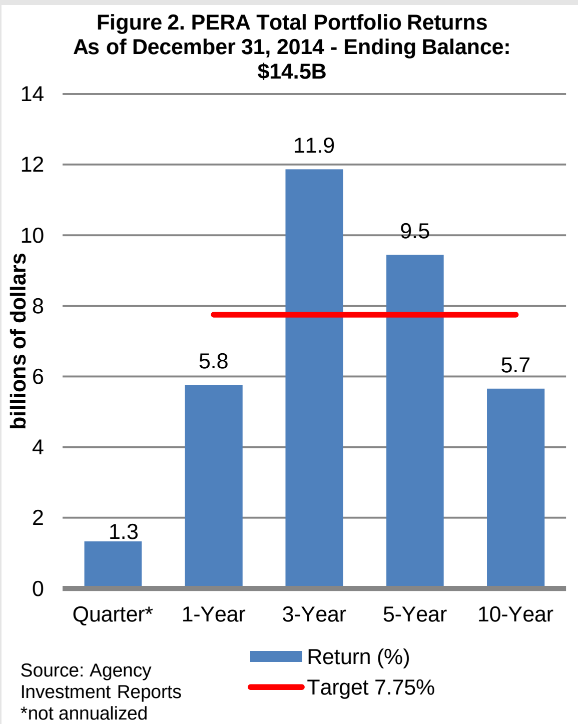
- The Wilshire Trust Universe Comparison Service (TUCS) notes global markets presented a mixed picture for U.S.-based investors during all of 2014, and the fourth quarter was no exception; domestic stocks and bonds enjoyed a quarter of strong performance, foreign asset performance varied depending on regional events and a global plunge in oil and natural gas prices introduced notable volatility into capital markets at year end. Further, NEPC noted The U.S. Dollar continues to strengthen against a basket of major currencies as the Fed ends its quantitative easing program.
- The U.S. stock market, represented by the Wilshire 5000 Total Market IndexSM, finished the year strong despite a basically flat December. The index was up 5.26% for the fourth quarter and 12.71% for all of 2014.
- NEPC reported international equities underperformed U.S. markets during the quarter, returning -3.9%, as measured by the MSCI ACWI ex-U.S. Index.
- On the fixed income side, NEPC reported risk aversion permeated fixed income markets in the fourth quarter amid growing concerns around global economic growth and geopolitical events.
- NEPC also added that it continues to be neutral on core real estate in the US and remains positive on non-core real estate

Returns and Ending Balances. Table 1 summarizes the agencies' investment returns for the quarter and for the one, three, five, and ten-year periods, as well as ending balances for the quarter December 31, 2014. This data is also represented in figures 1 through 4, which show that nly ERB's one-year returns exceed its long-term target return, while all three investment agencies' three- and five-year returns exceed their respective targets, which are 7.5 percent for SIC and 7.75 percent for ERB and PERA. Ten-year returns fall short of long-term targets because they reflect lesser investment performance during the global financial crisis, exacerbated by asset allocations that did not include diversification through alternative investments given policy restrictions at the time.

Table 1				
Returns and Ending Balances as of December 31, 2014				
Returns (%)	PERA	ERB	LGPF	STPF
Quarter	1.3	1.4	1.5	1.4
1-Year	5.8	8.0	6.8	6.6
3-Year	11.9	11.1	12.4	11.8
5-Year	9.5	9.5	10.0	9.5
10-Year	5.7	6.8	6.4	5.7
Ending Balance ($B)	14.3	11.3	14.5	4.7

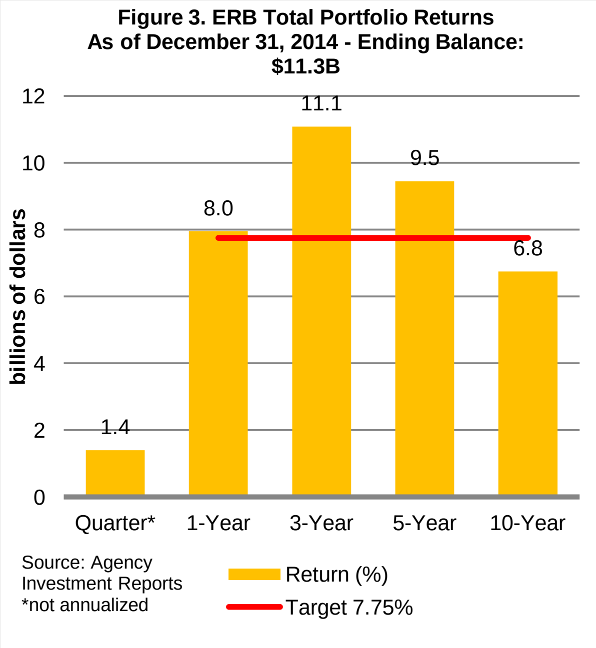
Source: Investment Agency Reports

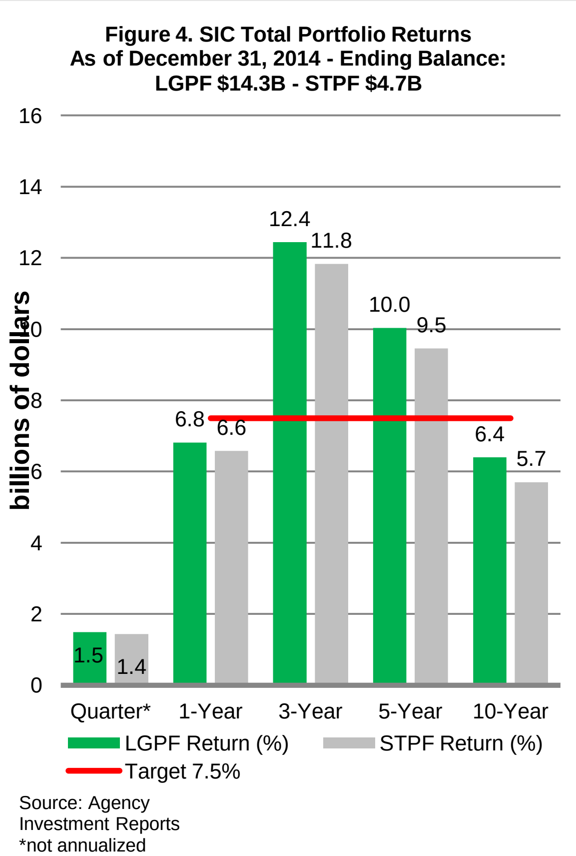
Figure 1 shows the quarter-ending balances of the major investment funds. The severance tax permanent fund (STPF) and land grant permanent fund (LGPF) are managed by SIC and therefore shown separately. A portion of the STPF is invested in economically targeted investments (ETIs) that typically perform below-market because the investments are not targeted solely at delivering returns. SIC notes ETIs' reduced levels of expected financial return are justified in statute by the expected economic development benefits that the investment is expected to deliver. The LGPF does not have ETIs 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.



<u>Investment Policy Objectives.</u> PERA's investment policy establishes the fund's primary objective is to prudently invest assets in order to meet statutory obligations to its members. The fund's assets are managed to reflect its unique liabilities and funding resources, incorporating accepted investment theory, prudent levels of risk and reliable, empirical evidence. Specifically, PERA's board has adopted the following principles:

- Strategic asset allocation is the most significant factor influencing long-term investment;
- Risk is unavoidable;
- Diversification both by and within asset classes is the fund's primary risk control element;
- The fund's liabilities are long term and the investment strategy must therefore be long-term in nature; and
- Sufficient liquidity will be maintained to meet anticipated cash flow requirements, including payments to beneficiaries.





ERB's investment philosophy and techniques are based upon a set of widely accepted investment models. The investment philosophy is summarized as follows:

- Develop and maintain strategic asset allocation (SAA) targets and ranges that optimally attain objectives of return and risk;
- When appropriate, ERB seeks to profit from capital market inefficiencies and market dislocations that may occur periodically;
- Investment positions take trading costs into consideration;
- Monitoring of investments and asset managers is a good administrative practice;
- Performance measurement and attribution analysis are essential in assessing effectiveness of investment strategies; and
- Rebalancing of the fund's assets is necessary for attainment of investment objectives.

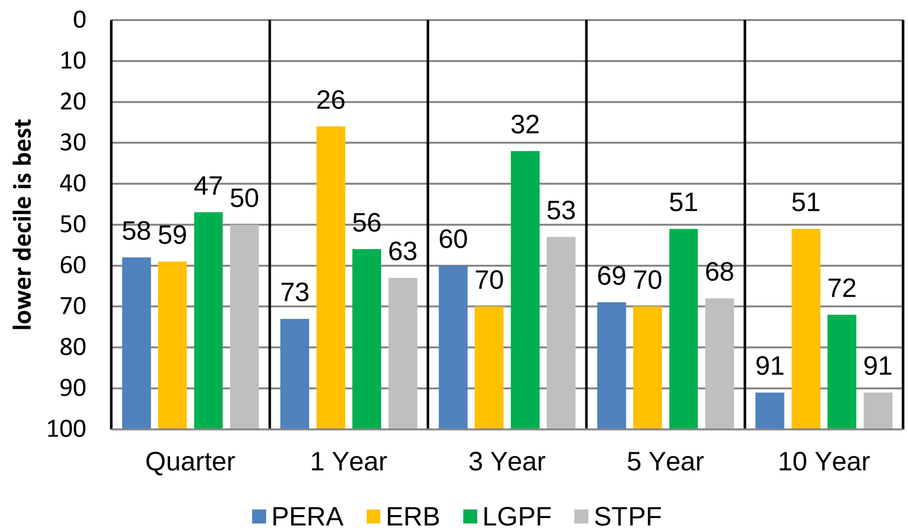
SIC's investment goals are to preserve the permanent endowment funds and to provide both current and future benefits by growing the funds at a rate at least equal to inflation. SIC seeks to manage the funds to ensure that future generations receive the same or greater benefits as current beneficiaries, while maximizing current distributions through time to provide current revenue sources to the state's general fund. Total return, which includes realized and unrealized gains, plus income, less expenses, is the primary goal of the funds. In order to meet the investment objective, the SIC has adopted the following principles:

- To preserve the purchasing power of the corpus and to provide benefits, the funds should have a long-term strategic asset allocation (SSA). The SSA is the most important determinant of return variability and long-term total return;
- Risk is an unavoidable component of investing;
- Diversification by asset class and within asset classes is a primary risk control element; and,
- Sufficient liquidity will be maintained to meet the anticipated cash flow requirements of the funds.

Peer Total Return Rankings. Figure 5 shows net-of-fees 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 public funds. These comparisons are made using the Wilshire Trust Universe Comparison Service (TUCS), a benchmark for the performance and allocation of institutional assets that includes approximately 60 public funds with more than $1 billion in assets. SIC notes not all of its investments report returns net-of-fees. In those cases, SIC's primary investment consultant (RVK) manually adjusts the returns by applying generic costs by asset class, a common practice performed by at least 95 percent of the funds included in TUCS. Because RVK does not have access to the active versus passive mix for any individual fund within the universe, SIC acknowledges in some cases the application of a generic fee could represent an inaccurate adjustment.

During the quarter, the return on all four funds fell between the 47th and the 59th percentile, compared with other funds in the universe. ERB's one-year ranking high in the second quartile exceeds the third-quartile ranking of the other three funds. Over the 5- and ten-year periods all New Mexico investment Funds' rankings among peer funds fall below the median, with the LGPF's 5-year ranking being highest at 51, and ERB's 10-year ranking being highest, also at 51.

Figure 5 - TUCS Universe Rankings
(public funds > $1 billion)
For Period Ending December 31, 2014



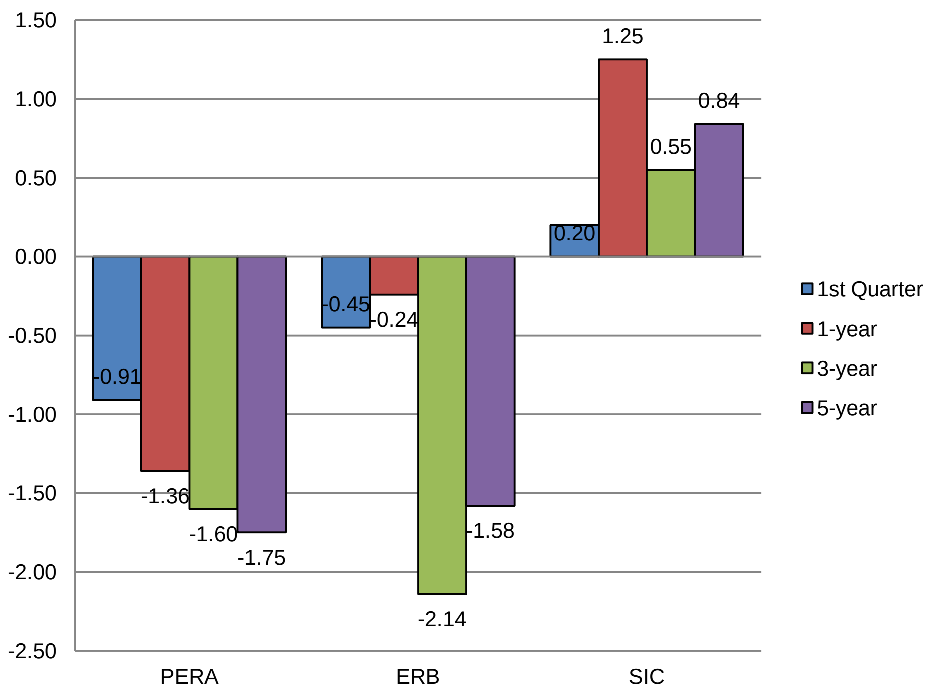
Staff from all three investment agencies indicate their respective performance rankings in the long-term are affected by limitations of their asset allocations at the time and by adverse economic conditions during the great recession. Therefore, before the agencies adjusted their investment policies toward more diversified portfolios through the use of alternative investments, the volatility of equity markets had a larger effect on their returns.

Attribution Analysis. There are three basic ways that a fund's returns can differ from the average: the policy, allocation, and manager effects.

Policy Effect. A fund can have a long-term policy allocation target that has a more or less aggressive proportion of growth assets such as stocks. For instance, if return-seeking domestic assets such as U.S. stocks (equities) performed well during a period, an index that has more domestic equities should outperform the average. Measured in isolation against a defined peer group, such a change in performance is known as the "policy effect," and it is an essential responsibility of the fund's trustees based on investment mandate, need for liquidity and associated asset allocations.

Figure 6 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 9, on page 8 of this report.)

Figure 6 - Quarterly, One-, Three-, and Five-Year Policy Effect (%) For Period Ending 13/31/14



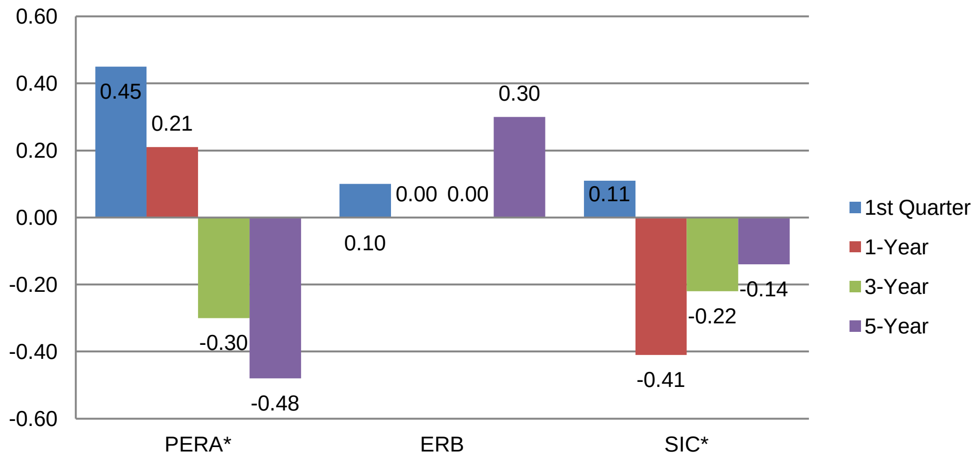
PERA's policy index lagged the median fund during the all periods. ERB's policy index performance lags that of the median fund for all periods as well, although to a lesser extent in the short term than in the long term. SIC's LGPF policy index performed 0.2 percent above the median fund in the quarter and 1.25 percent in the one-year period. The respective three- and five-year policy effects of 0.55 percent and 0.85 percent are above the median fund performance.

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.

Because asset prices and values can vary in the short run, they can cause the allocation toward an asset class to drift from its long term target. Almost all rebalancing policies allow some flexibility for the investment staff to operate within set boundaries. The three agencies 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. In addition, new investment mandates can take years to implement (i.e. private assets). The chief 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 vehicle, depending on policy authority. Rebalancing authority afforded to the chief investment officer is dictated by investment policy, resulting in differing degrees of authority delegated by each fund.

The investment return added or lost due to the difference between the funds' temporary and long-term allocation is known as the "allocation effect". Figure 7 shows the allocation effect graphically for the quarter, one-year, three-year, and five-year periods.

Figure 7 - Quarterly, One-, Three-, and Five-Year Allocation Effect (%) For Period Ending 9/30/14



* includes value of "other" for a net effect

PERA's allocation effect added 0.45 percent to the investment return during the quarter due primarily to underweight in domestic equity and added value from fixed income. For the one-year period, an overweight to domestic equitiy and underweight to fixed income added value, offset partially by lost value due to overweight international equity and underweight private equity. Deviations from the target asset allocation detracted 30 basis points in the three-year period with value added from underweight domestic equity being erased due to underweight international equity and private equity. The five-year period shows a negative allocation effect of 0.48 percent, the biggest contributor to which was an underweight to private equity.

ERB's allocation effect for the quarter was 0.1 percent while the one- and three-year periods showed a net zero percent allocation effect, meaning value gained or lost due to deviations from target allocations in different asset classes were offsetting. The agency's five-year allocation effect was 0.3 percent.

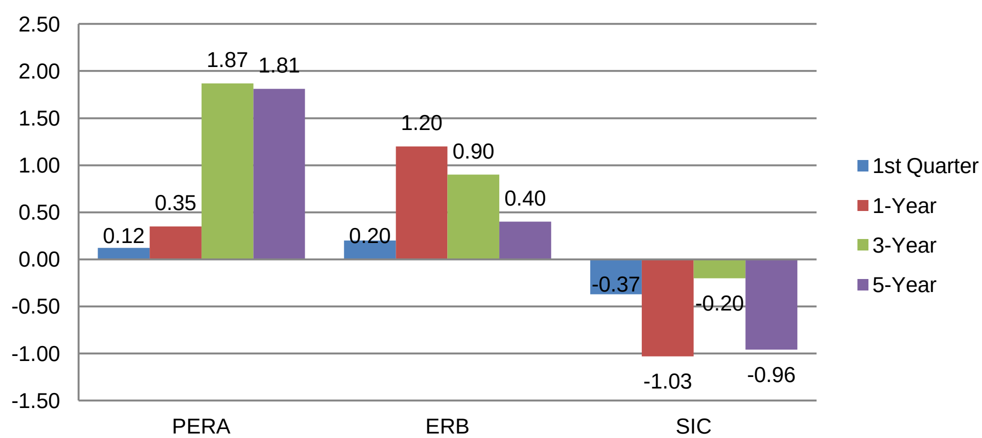
The SIC's investment of the land grant permanent fund saw 0.11 percent gains due to the allocation effect in the quarter, largely due to an underweight to international equity. The one-year allocation effect of -.41 results from value lost in fixed income, private equity, and cash, partially offset by value added in international equity.

Manager Effect. The third way that value can be added or subtracted from a fund's returns is through the use of active management. In this case, the agency can employ a manager who will trade individual securities given his or her perspective of individual stocks. This is known as "active" investing. The difference between the return of the index fund and the portfolio of the active manager is known as the "manager effect."

Figure 8 shows manager effects for all three agencies during the quarter, one-year, three-year, and 5-year periods. PERA's manager effect in the quarter and one-year periods was minimal compared to stock selection gains in the longer periods. These gains were largely influenced by active management in fixed income and domestic equity. ERB's manager effect in the quarter was relatively small compared with the effect for the one- and three- year periods, when management in opportunistic credit added value. SIC's negative manager effects[1] during the one-year and five-year periods were driven by

SIC notes its manager effects in the longer term is influenced by previous managers, adding current staff have made portfolio restructurings that have been in place for a short time.

Figure 8 - Quarterly, One-, Three-, and Five-Year Manager Effect (%) For Period Ending 12/31/14



[1] The SIC notes that its net-of-fees performance analysis is based upon an estimate of SIC's investment performance developed by RVK.

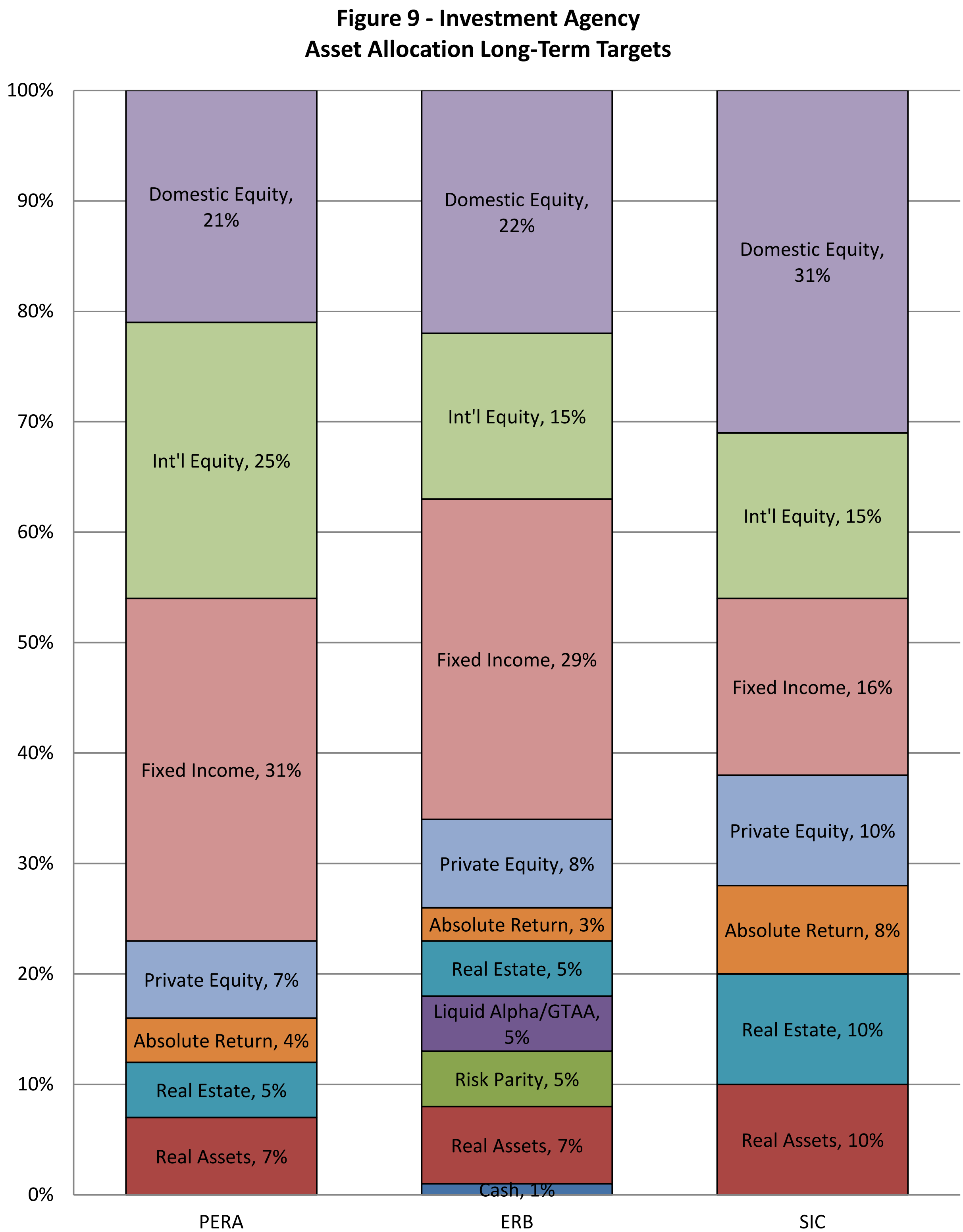


Figure 9 - Investment Agency
Asset Allocation Long-Term Targets
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Domestic Equity, 21%
Int'l Equity, 25%
Fixed Income, 31%
Private Equity, 7%
Absolute Return, 4%
Real Estate, 5%
Real Assets, 7%
Domestic Equity, 22%
Int'l Equity, 15%
Fixed Income, 29%
Private Equity, 8%
Absolute Return, 3%
Real Estate, 5%
Liquid Alpha/GTAA, 5%
Risk Parity, 5%
Real Assets, 7%
Cash, 1%
Domestic Equity, 31%
Int'l Equity, 15%
Fixed Income, 16%
Private Equity, 10%
Absolute Return, 8%
Real Estate, 10%
Real Assets, 10%
PERA
ERB
SIC