State of New Mexico
LEGISLATIVE FINANCE COMMITTEE

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LFC INVESTMENT REPORT FOR THE QUARTER ENDING DECEMBER 31, 2015

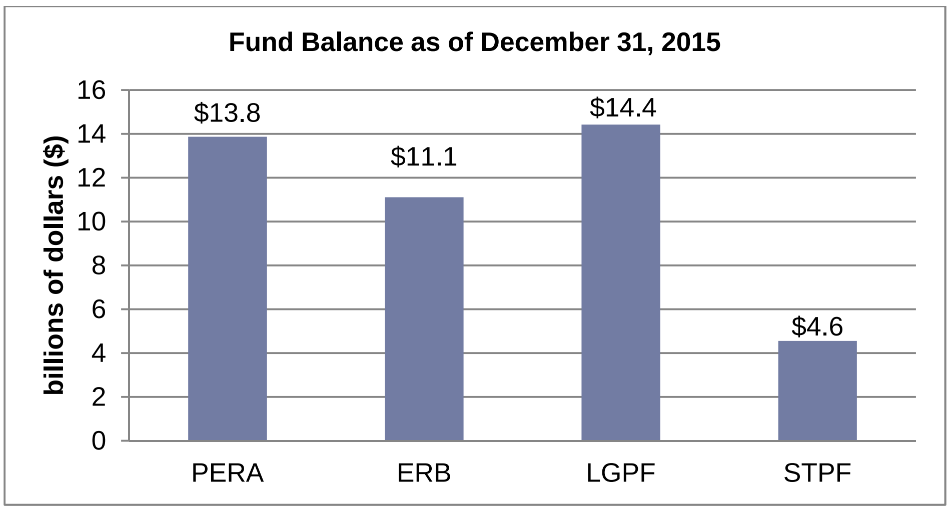
This report details the comparative investment performance of the three investment agencies: the Educational Retirement Board (ERB), the Public Employees Retirement Association (PERA), and the State Investment Council (SIC). The report outlines how the returns generated by these agencies differed from that of the archetypical public investment fund and how management and consultants added or subtracted value. As long-term performance is an important metric, this report includes fund returns and comparative rankings for the one, three, five, and ten-year periods and risk metrics for the quarter ended December 31st, one, three and five-year periods.

Market Environment.

- For the first time since 2007, the U.S. Federal Reserve announced at the December meeting it would raise the target range for interest rates from 0.00-0.25 percent to 0.25-0.50 percent. Federal Reserve Chair Janet Yellen stated that indicators of strength in economic data presented the appropriate time for raising rates.
- China's economic activity began to recover from the tumultuous previous quarter but not after causing major and lasting negative effects on global markets and downward pressure on commodities.
- The final quarter of 2015 continued to see solid jobs growth nationally and real GDP rise 2.6 percent year-over-year while consumer inflation remained below 2 percent per year for four consecutive years.
- Lower demand combined with excess supply and a warm winter, pulled crude oil down over 25 percent during the quarter, ending at $37.04/barrel, extending the bear market for oil futures.
- As observed in the Market Environment Table on the following page, the U.S. stock market was positive during the quarter providing a rally to end the previous quarter's negative performance.
- Global monetary policies continued to remain 'lower for longer' as quantitative easing and negative interest rates provided short term support for markets in Europe and Japan while suppressing long term expected returns for equity and fixed income investments.
- The U.S. dollar continued to remain strong against benchmark global and emerging markets currencies.

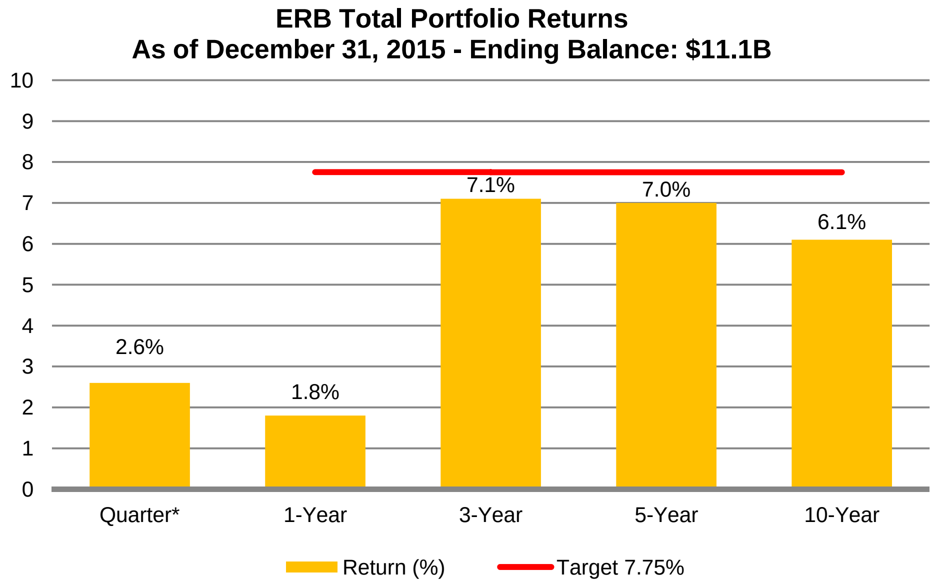
Market Environment as of December 31, 2015				
Index Returns (%)	**Q4 2015**	**1 Year**	**5 Years**	**10 Years**
S&P 500	7.0	1.4	12.6	7.3
Wilshire 5000	6.4	0.7	12.1	7.4
Russell 3000	6.3	0.5	12.2	7.4
Dow Jones Industrial	7.7	0.2	11.3	7.8
MSCI EAFE	4.7	-0.8	3.6	3.0
Barclays Govt/Credit	-0.7	0.2	3.4	4.5

Returns and Ending Balances. The tables below summarize the ending balances for the quarter December 31, 2015 as well as the agencies' investment returns for the quarter and for the one, three, five, and ten-year periods, on the following page.

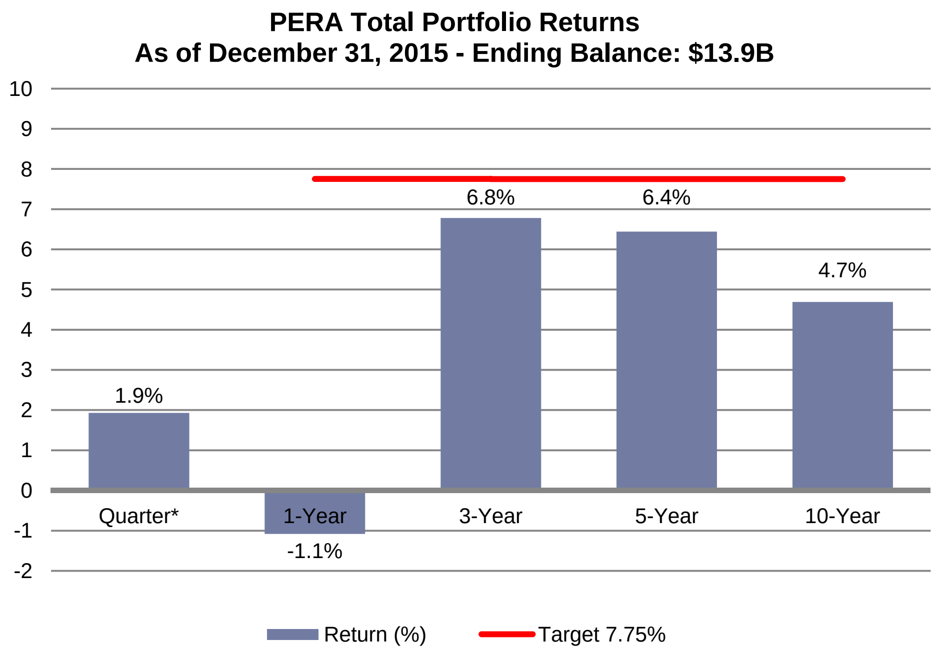


The second quarter of the fiscal year, continued to challenge the investment agencies' fund balances. Strong market volatility resulting from macro activities has caused the agencies to struggle to meet their return targets. The short term one year period was especially sensitive to volatility in global markets and a continued drop in the oil market which has diminished investment balances and long term potential returns. The longer investment periods reflect the economic and market post-recession recovery after 2009. Ten-year returns fall short of long-term targets because they reflect challenged investment performance during the global financial crisis. Long range performance also reflects narrow investment portfolio diversification through the restriction of alternative asset investments given policy terms in place at the time. All three investment agencies have since actively pursued diversifying and creating depth in their respective portfolios to permit fewer investment losses during continued periods of broad market swings and volatility.

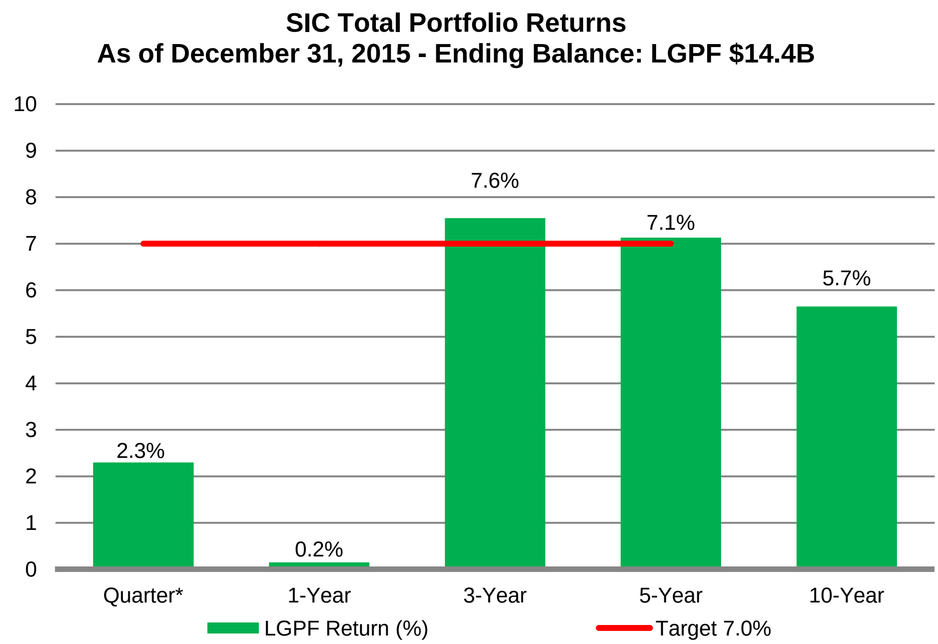
Each of the portfolios has a return policy target in place. ERB and PERA are set at 7.75 percent. At the Council's October meeting, SIC received approval to lower the investment target for LGPF from 7.5 percent to 7.0 percent and for STPF from 7.5 percent to 6.75 percent. The lower target for STPF considers the inclusion of economically targeted investments (ETIs). The decision for lowering the targets included a review of factors including the distribution policy, maintaining intergenerational equity, future return expectations and risk levels. Significantly lower contributions from the State Land Office due to the broad decline in oil prices over the last year, presented pressure for investments to generate larger returns as an off-set to keep the LGPF and STPF healthy. SIC noted that future return assumptions in volatile markets have steadily declined throughout the investment industry over the last eight years. Incorporating a re-evaluation of portfolio structures and investment opportunities combined with lower return targets, SIC would be able to maneuver in a risk range with set return expectations that are achievable.



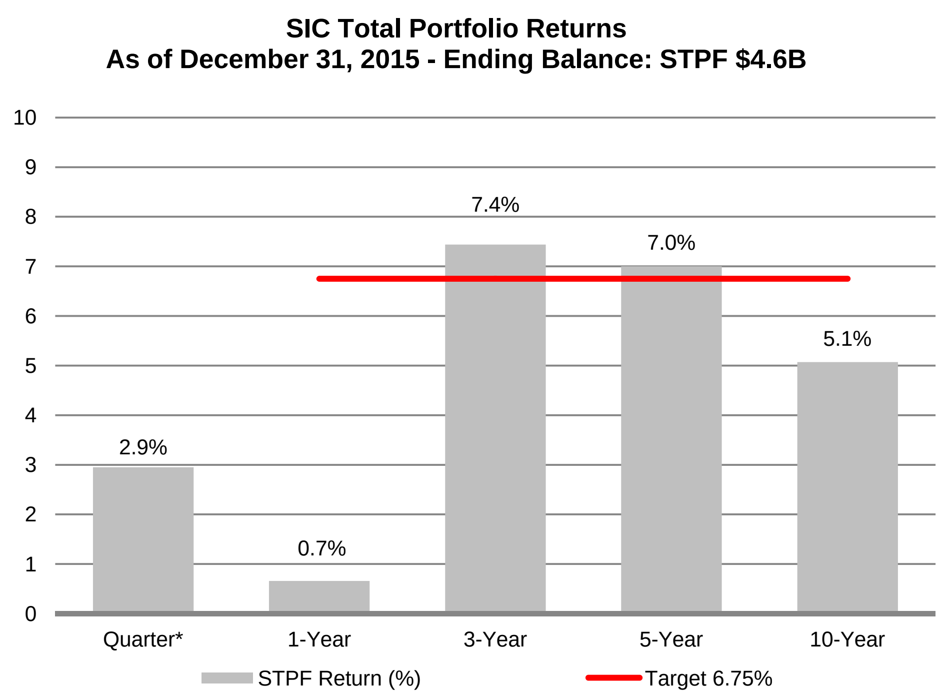
Source: Investment Agency Reports
*not annualized



Source: Investment Agency Reports
*not annualized



Source: Investment Agency Reports
*not annualized



Source: Investment Agency Reports
*not annualized

The Severance Tax Permanent Fund (STPF) and Land Grant Permanent Fund (LGPF), managed by SIC, are 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 states that 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.

Investment Portfolio Policy Objectives.

PERA's investment policy states that the pension 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. The actuarial assumed target rate of return is the key actuarial assumption affecting future funding rates and payment of pension obligations. Investment performance that exceeds or underperforms the target rate may materially impact future funding rates.

ERB's investment philosophy and techniques are based upon a set of widely accepted investment models. ERB is focused on the prudent investment and management of its members' contributions to the retirement fund, utilizing techniques tempered by experience and knowledge. The investment goal is to earn an inflation-adjusted return sufficient to attain the target funding level over a long term period.

SIC's investment goals are to preserve the permanent endowment funds and to provide for current and future beneficiaries by growing the funds at a rate to keep pace with inflation to maintain value over a long-term time horizon. 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.

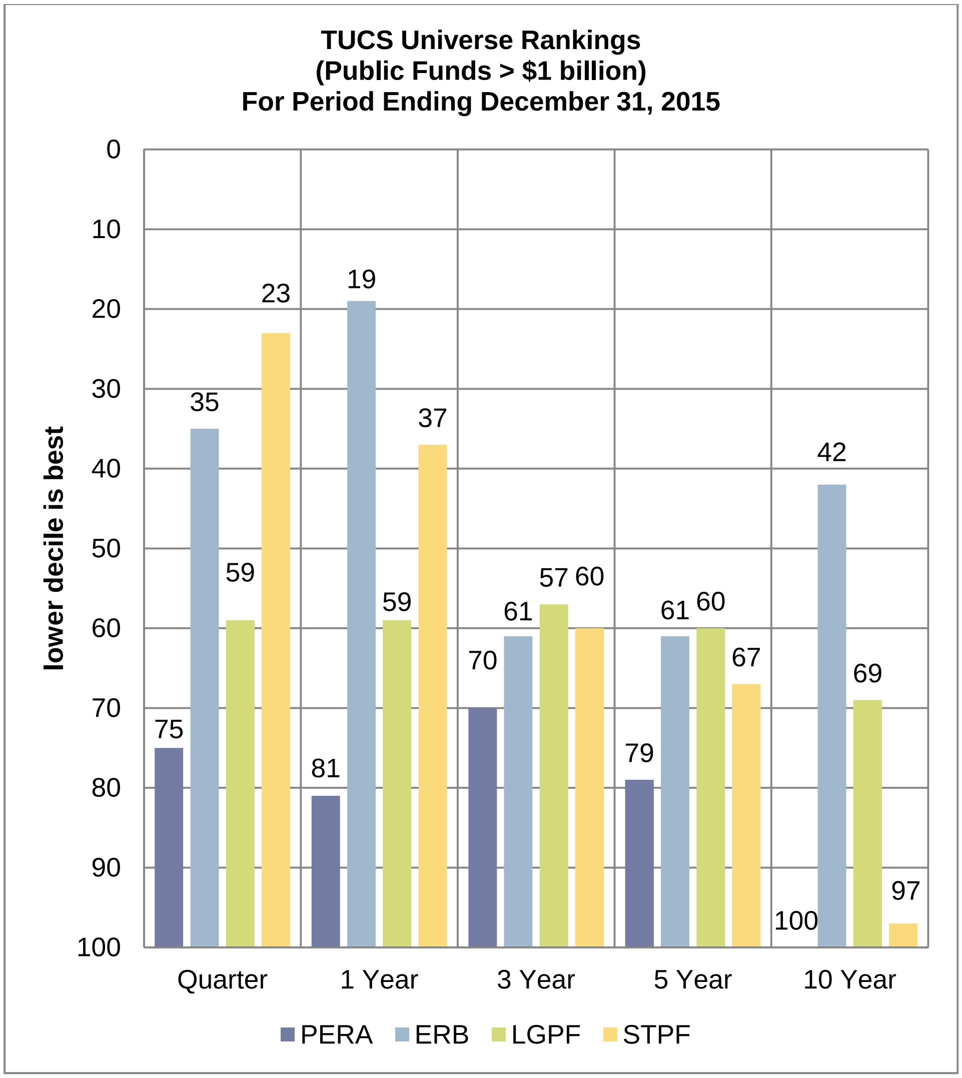
Peer Total Return Rankings.

The following table 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 within a comparable investment universe. These comparisons are completed by the Wilshire Trust Universe Comparison Service (TUCS), a benchmark service which evaluates the performance and allocation of institutional investment assets. New Mexico's investment agencies are evaluated alongside approximately 50 public funds with more than $1 billion in assets. SIC notes not all of its investments report returns net-of-fees[1].

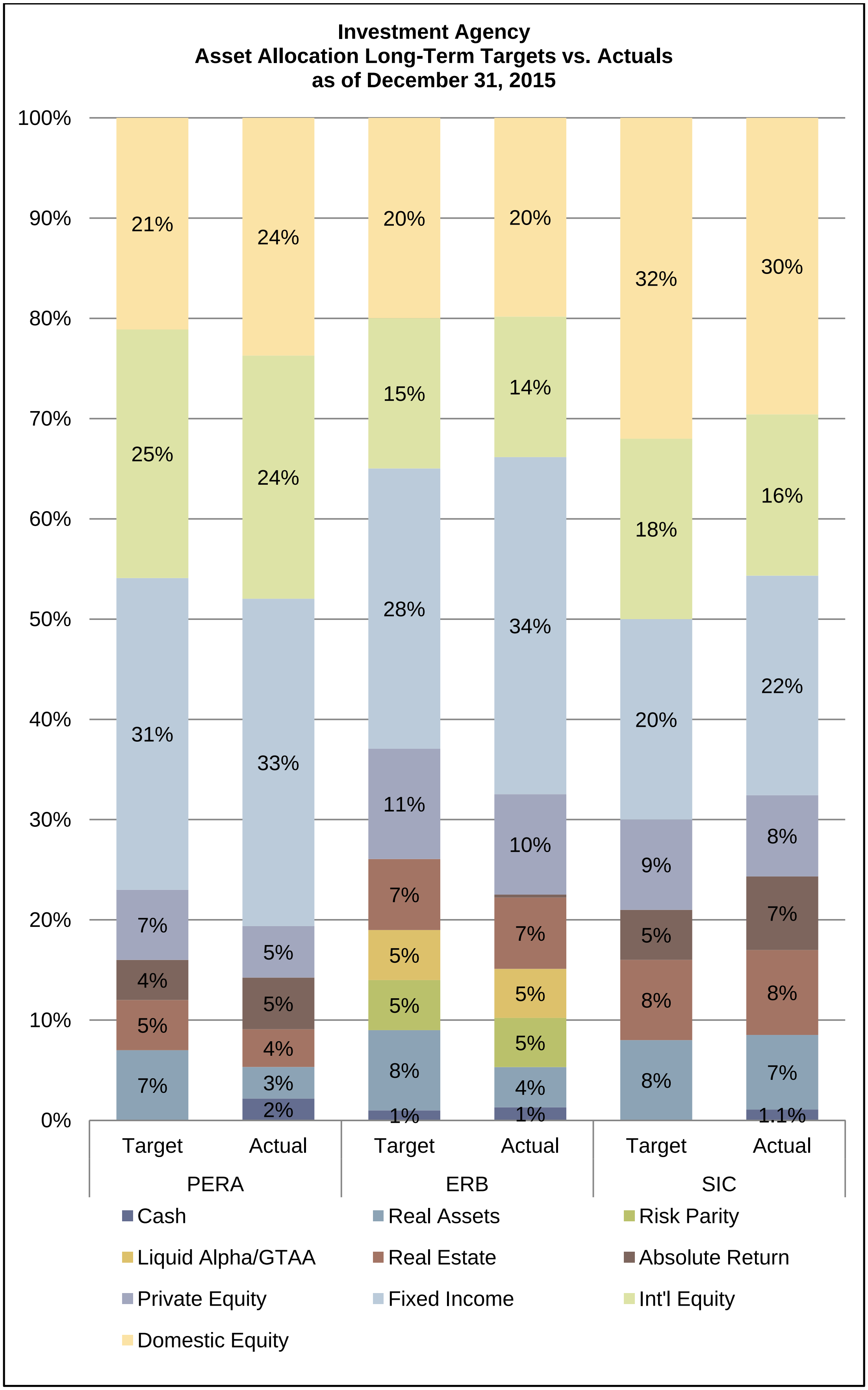
During the second quarter, the four funds improved over the quarter prior. Overall the returns varied for the periods reviewed and fell across a broad range of rankings when compared against comparable funds in the universe. STPF and ERB ranked at the 23rd and 37th percentiles respectively, performing very well and above LGPF and PERA which ranked at the 59th and 75th percentiles respectively. During the course of the fiscal one-year, STPF and ERB outperformed. Over the longer ten-year period ERB continues to

[1] 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. As SIC's investment advisor, 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 estimated adjustment. The rankings reported in the table reflect gross of fees for LGPF and STPF.

perform well towards meeting its long term investment goals. LGPF and PERA both underperformed for every period and all funds under returned for the 3 and 5 year period.



Staff from all three investment agencies acknowledge their respective performance rankings in the long-term are impacted by policy limitations of their asset allocations during the measured time periods and by extreme economic conditions during the great recession. As the agencies adjusted their investment policies to permit diversified portfolios through the inclusion of alternative investments, the volatility of equity markets had a stronger impact on their returns. As long as the investment agencies meet or exceed their annual return targets in the short- and mid-terms, there is an expectation their long-term (10 years and greater) performance rankings will improve over time.


Investment Agency
Asset Allocation Long-Term Targets vs. Actuals
as of December 31, 2015
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
21%
25%
31%
7%
4%
5%
7%
24%
24%
33%
5%
5%
4%
3%
2%
20%
15%
28%
11%
7%
5%
5%
8%
1%
20%
14%
34%
10%
7%
5%
5%
4%
1%
32%
18%
20%
9%
5%
8%
8%
30%
16%
22%
8%
7%
8%
7%
1.1%
Target
Actual
PERA
ERB
SIC
Cash
Real Assets
Risk Parity
Liquid Alpha/GTAA
Real Estate
Absolute Return
Private Equity
Fixed Income
Int'l Equity
Domestic Equity