State of New Mexico
LEGISLATIVE FINANCE COMMITTEE

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Director

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LFC INVESTMENT REPORT FOR THE QUARTER ENDING JUNE 30, 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 attribution analysis for the quarter ended June 30th, one, and three-year periods.

Market Environment.

- Global macro and political events continued to dominate the headlines during the quarter. China struggled to maintain economic momentum, Greece’s default on its crippling debt rippled throughout the Eurozone, the U.S. wrestled with the oil economy and Emerging Markets began to rise from the depths experienced earlier in the year.
- The markets moved sideways as various sectors pushed strongly to opposing ends; energy, utilities and industrials were down while health care, financials and consumer discretionary pulled performance into the positive range.
- The oil and commodities markets continued to struggle with global market volatility. Brent and WTI crude oil prices increased close to 15% during the second quarter as the market continued to work through strong excess supply of refined products.
- Real GDP was down slightly during the second quarter of 2015, contracting -0.2%. Personal consumption growth was positive while exports declined. The Consumer Price Index continued its increase this year, climbing an additional 1.07% for the quarter; driven primarily by energy and food prices. The inflation rate held steady at a low level of 1.87%, unchanged from the prior quarter.
- The national unemployment rate improved over the year, decreasing to 5.3% in June.
- The U.S. Federal Reserve continued to shy away from raising short-term interest rates during the second quarter driven in large part by uncertainty around continued market volatility. In response to

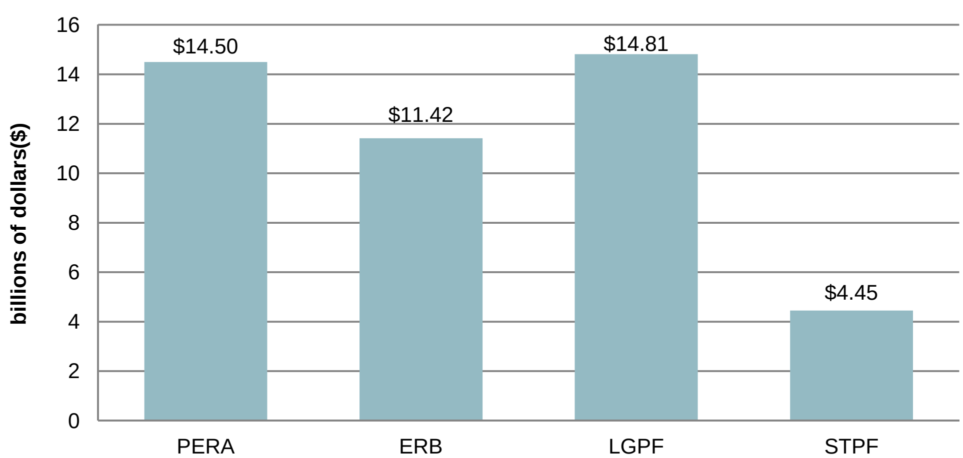
the growing sentiment around the anticipated upcoming federal rate increase, the rates across most maturities of longer duration climbed higher over the quarter. Ten year treasury notes rose 41 basis points to 2.35%.

- Stagnant corporate earnings growth and extensive investor shifts out of low interest bonds drove the credit spreads wider.
- The U.S. dollar weakened against benchmark global currencies, which led to improved performance for dollar-based investors. Emerging markets currencies remained depressed against the USD.

Market Environment as of June 30, 2015				
Index Returns (%)	**Q2 2015**	**1 Year**	**5 Years**	**10 Years**
S&P 500	0.3	7.4	17.3	7.9
Wilshire 5000	0.1	7.1	17.3	8.2
Russell 3000	0.1	7.3	17.5	8.2
Dow Jones Industrial	-0.3	7.2	15.4	8.3
MSCI EAFE	0.6	-4.2	9.5	5.1
Barclays Govt/Credit	-2.1	1.7	3.5	4.4

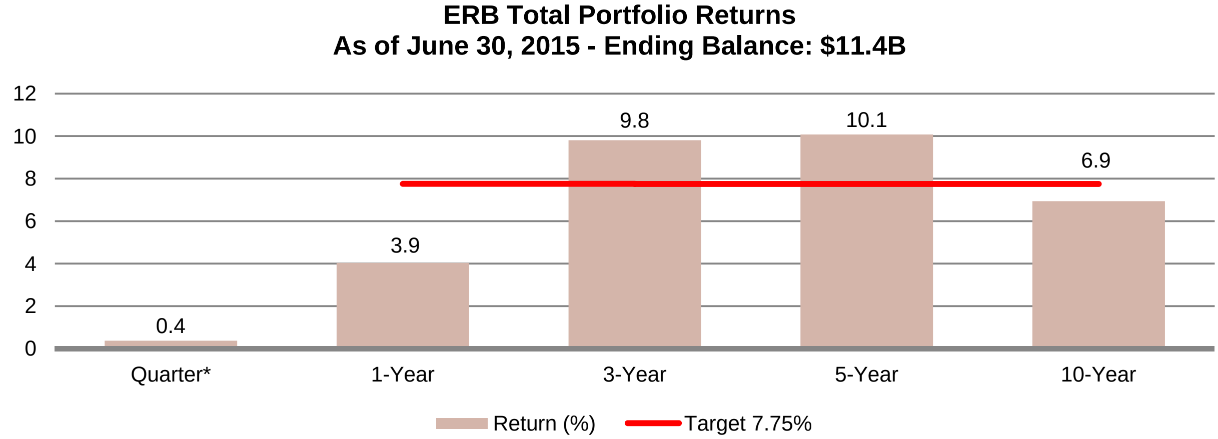
Returns and Ending Balances. The table below summarizes the ending balances for the quarter June 30, 2015 as well as the agencies' investment returns for the quarter and for the one, three, five, and ten-year periods, on the following page.

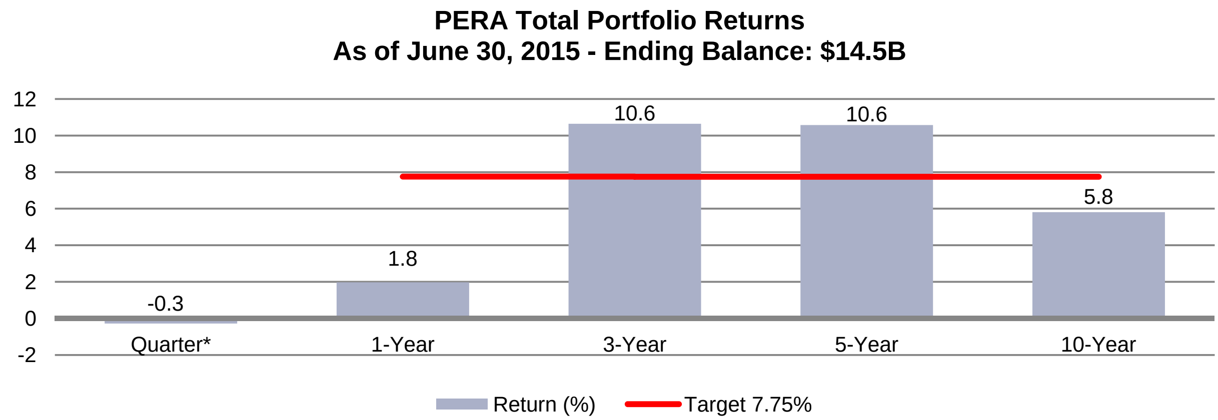
Fund Balance as of June 30, 2015

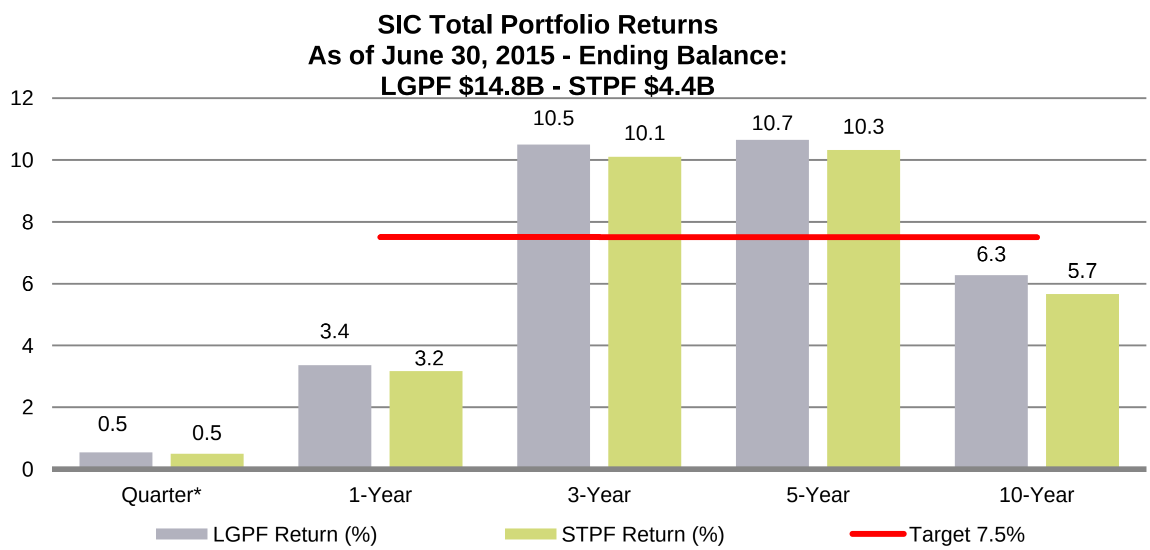


Source: Investment Agency Reports

During the last fiscal year, all of the agencies' investment returns struggled to meet their one-year target return. The longer investment returns for three- and five-years continued to exceed their respective targets, which are set at 7.5 percent for SIC and 7.75 percent for ERB and PERA. The longer investment periods reflect the increased economic and market post-recession recovery. Ten-year returns fall short of long-term targets because they reflect challenged investment performance during the global financial crisis. The long range performance also reflects less investment portfolio diversification through alternative asset allocations to investments given the policy restrictions in place at the time. All three investment agencies have actively pursued diversifying and creating depth in their respective portfolios to permit lower investment losses during periods of broad market swings and volatility.







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 claims 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 Portfolio Policy Objectives.</u>
PERA's investment policy establishes 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. 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. 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. 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.

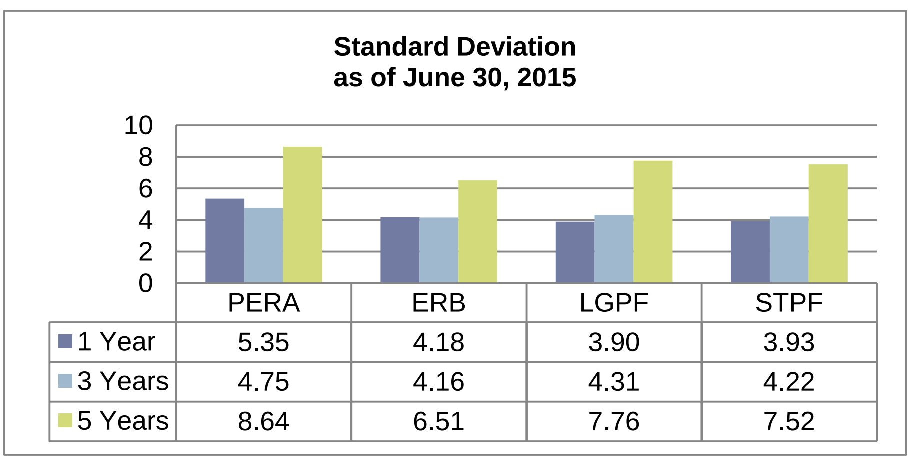
SIC's investment goals are to preserve the permanent endowment funds and to provide for current and future beneficiaries by growing the funds at a rate to keep pace with inflation to maintain value over a long-term time horizon. SIC seeks to manage the funds to ensure that future generations receive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

<u>Risk Metrics.</u>

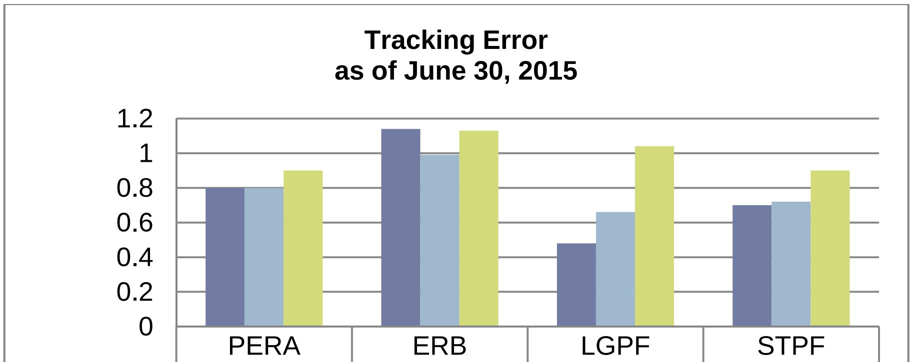
Risk is an inherent component of investing in financial markets. As risk of an investment fund is a function of the strategic asset allocation it is prudent to keep the risk levels within tolerant levels to achieve the overall goals of the plan. To evaluate the impact that risk plays in an investment portfolio, there are a few key measures which may be utilized.

- Standard deviation is used to gauge the variability of returns around a mean of distribution. Standard deviation is typically applied to the rate of return of a portfolio to measure the overall volatility. A higher standard deviation number is expected for more volatile investments, while a lower number would be associated with low volatility investments.
- Reviewing the table below, all of the portfolios experienced volatility over the one year time period, with PERA having the highest sensitivity and the LGPF and STPF were more muted. The five year period saw stronger volatility overall. This may be attributed in part to broad global macro events impacting the portfolios more directly as well as larger holdings in absolute return (hedge fund) investments.



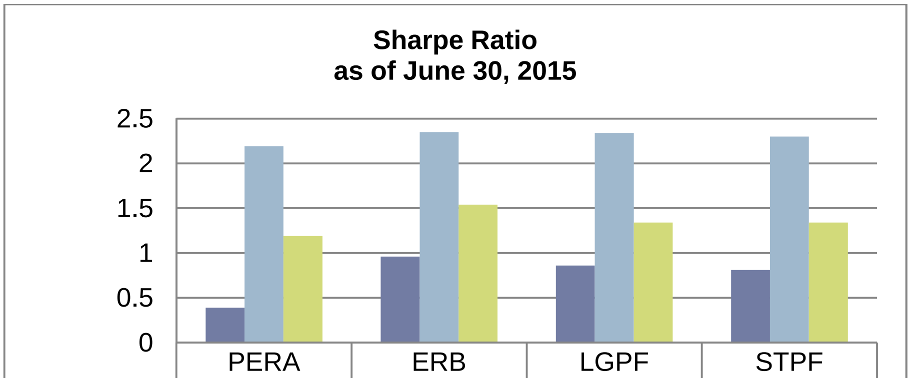
- After reviewing the standard deviation, the tracking error outlines the difference between the return of the portfolio investment and the benchmark.

- Over the last three years, the implementation of revised asset allocations for the portfolios have begun to take effect as seen in the tracking error reported below. The portfolios show risk profiles that are not identical to their benchmarks, reflecting investment skill of managers hired.



	PERA	ERB	LGPF	STPF
1 Year	0.8	1.14	0.48	0.70
3 Years	0.8	0.99	0.66	0.72
5 Years	0.9	1.13	1.04	0.90

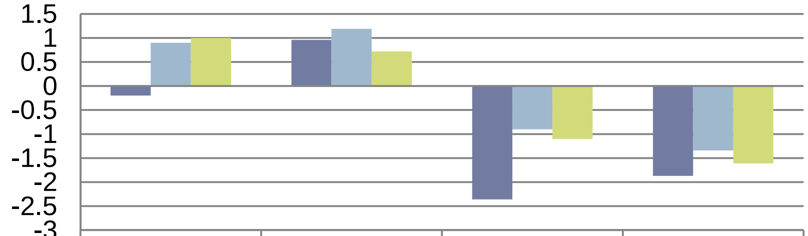
- The Sharpe ratio is a risk-adjusted measure that is calculated by using the standard deviation and the fund's excess return to evaluate reward per unit of risk. The higher the ratio, the better the risk-adjusted performance for the investment fund.
- ERB, LGPF and STPF held steady during the fiscal year, while PERA lagged in risk-adjusted performance. The three year period reflects positive performance for higher risk investments during a time when the economic recovery was gaining momentum.



	PERA	ERB	LGPF	STPF
1 Year	0.39	0.96	0.86	0.81
3 Years	2.19	2.35	2.34	2.30
5 Years	1.19	1.54	1.34	1.34

- The information ratio evaluates the ratio of portfolio returns above the benchmark to the volatility of the returns. The ability of the manager to generate excess returns against the benchmark is reviewed as well as their consistency in performance. The higher the information ratio, the more consistent the manager.

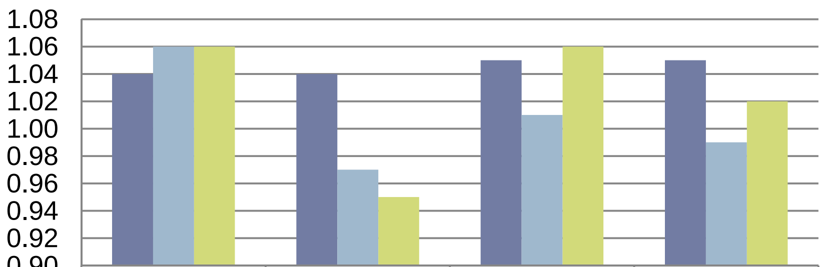
Information Ratio
as of June 30, 2015



	PERA	ERB	LGPF	STPF
1 Year	-0.2	0.96	-2.36	-1.87
3 Years	0.9	1.19	-0.90	-1.34
5 Years	1.0	0.72	-1.10	-1.61

- The beta of a portfolio signifies the volatility of the portfolio versus the investment market. If the beta is approximately equal to '1', then there is very strong correlation between the portfolio and the movements of the market. If the beta is lower than '1', then the portfolio will be less volatile than the market.
- ERB's portfolio has historically held steady with lower volatility and lower correlation with market swings. The influence of global macro events combined with the drop in oil pricing has brought turbulence to state's portfolios over the last year as seen in reported betas above '1'.

Beta
as of June 30, 2015



	PERA	ERB	LGPF	STPF
1 Year	1.04	1.04	1.05	1.05
3 Years	1.06	0.97	1.01	0.99
5 Years	1.06	0.95	1.06	1.02

Management Fees.

For the fiscal year 2015, the investment agencies presented a compilation of management fees for the investment portfolios at the Investments and Pensions Oversight Committee meeting. The fees included the management, administrative, audit, operational and staff costs associated with administering the investment plans.

Educational Retirement Board - Asset Management Fees Paid FY 2015

Asset Class	Management Fees	Performance Fees	Total	Percentage	Annual Cost (in bps)
Domestic Equity	$ 2,569,863	$ -	$ 2,569,863	2.00%	10
International Equity	$ 11,241,491	$ -	$ 11,241,491	8.73%	66
Fixed Income	$ 2,256,176	$ 408,998	$ 2,665,174	2.07%	18
Private Equity	$ 18,333,994	$ 5,555,750	$ 23,889,744	18.56%	98
Real Estate	$ 4,743,376	$ 4,804,940	$ 9,548,316	7.42%	56
Real Returns	$ 14,003,061	$ 168,274	$ 14,171,335	11.01%	168
Hedge Funds	$ 2,294,833	$ 491,306	$ 2,786,139	2.16%	179
Opportunistic Credit	$ 35,769,530	$ 11,255,950	$ 47,025,480	36.53%	123
GTAA	$ 6,639,515	$ 6,133,645	$ 12,773,160	9.92%	114
Risk Parity	$ 2,052,195	$ -	$ 2,052,195	1.59%	35
Totals	**$ 99,904,034**	**$ 28,818,863**	**$ 128,722,897**	**100.00%**	**73**

The Fund returned 3.9% for FY 2015 and generated $449 million in investment gain (net of fees).

ERB paid the highest amount of fees at 73 basis points, in proportion to the overall fund. This may in large part be attributed to the portfolio's sizable allocation to opportunistic credit investments. This is an alternative investment category with a risk profile higher than traditional investments and lower risk than various other alternative investments including private equity. The opportunistic credit investments have performed well for the ERB portfolio. PERA and SIC have little to no investments in this asset class.

Public Employees Retirement Association - Asset Management Fees Paid FY 2015

Asset Class	Management Fees	Performance Fees	Total	Percentage	Annual Cost (in bps)
Domestic Equity	$ 6,857,753	$ -	$ 6,857,753	6.92%	24
International Equity	$ 6,139,829	$ -	$ 6,139,829	6.20%	17
Fixed Income	$ 6,735,249	$ -	$ 6,735,249	6.80%	17
Private Equity	$ 7,580,718	$ 6,983,000	$ 14,563,718	14.70%	67
Real Estate	$ 8,681,999	$ 4,916,701	$ 13,598,700	13.73%	118
Real Returns	$ 6,869,758	$ 3,263,045	$ 10,132,803	10.23%	93
Hedge Funds	$ 20,655,045	$ 18,408,469	$ 39,063,514	39.44%	144
Credit & Structured Finance	$ 1,950,000	$ -	$ 1,950,000	1.97%	26
Totals	**$ 65,470,351**	**$ 33,571,215**	**$ 99,041,566**	**100.00%**	**42**

The Fund returned 1.8% for FY 2015 and generated $336 million in investment gain (net of fees).

PERA's presented the lowest amount of fees paid for investments during the fiscal year at an annual cost of 42 basis points. The majority of management fees were attributed to the alternative investments, less efficient asset categories; with hedge funds accounting for nearly 40% of all fees.

State Investment Council - Asset Management Fees Paid FY 2015

Asset Class	Management Fees	Performance Fees	Total	Percentage	Annual Cost (in bps)
Domestic Equity	$ 1,554,439	$ -	$ 1,554,439	1.01%	22
International Equity	$ 11,656,333	$ -	$ 11,656,333	7.61%	43
Fixed Income	$ 6,289,826	$ -	$ 6,289,826	4.11%	17
Private Equity	$ 27,016,148	$ 526,031	$ 27,542,179	17.98%	89
Real Estate	$ 14,469,735	$ 14,302,559	$ 28,772,294	18.79%	68
Real Returns	$ 12,717,685	$ 2,115,464	$ 14,833,149	9.68%	56
Hedge Funds*	$ 29,551,653	$ 9,244,090	$ 38,795,743	25.33%	206
Credit & Structured Finance*	$ 15,796,626	$ 7,916,551	$ 23,713,177	15.48%	173
Totals	**$ 119,052,445**	**$ 34,104,695**	**$ 153,157,140**	**100.00%**	**57**

** Fees from 12/31/2014 audited financials estimated for FY 2015.*

The Fund returned 3.58% for FY 2015 and generated $715 million in investment gain (net of fees).

The SIC paid a large portion of its fees in fiscal year 2015 for investments in hedge funds and credit and structured finance. As fees tend to be driven by strategic asset allocation and risk profile, SIC exhibits a broadly diversified investment program for which performance comes a larger cost. As the fund is larger in investable asset size than ERB and PERA, the scale lends itself to larger fees overall.

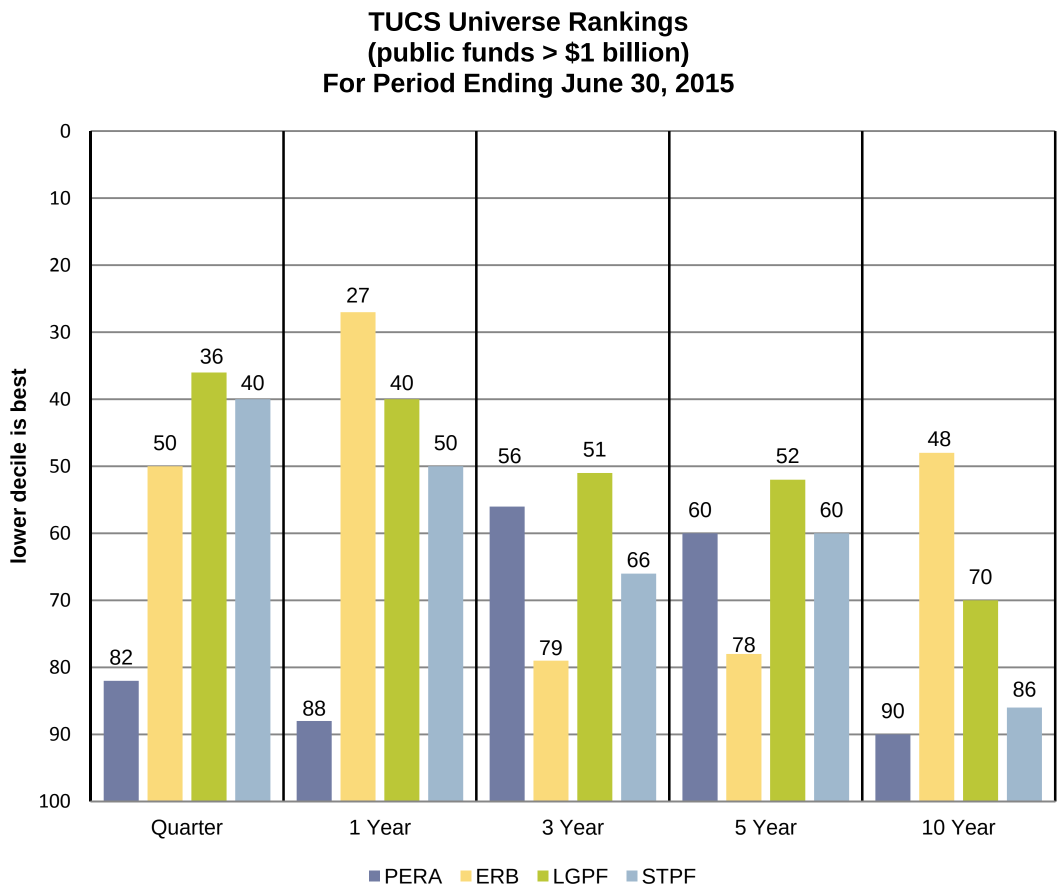
<u>Peer Total Return Rankings</u>.

Figure 4 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].

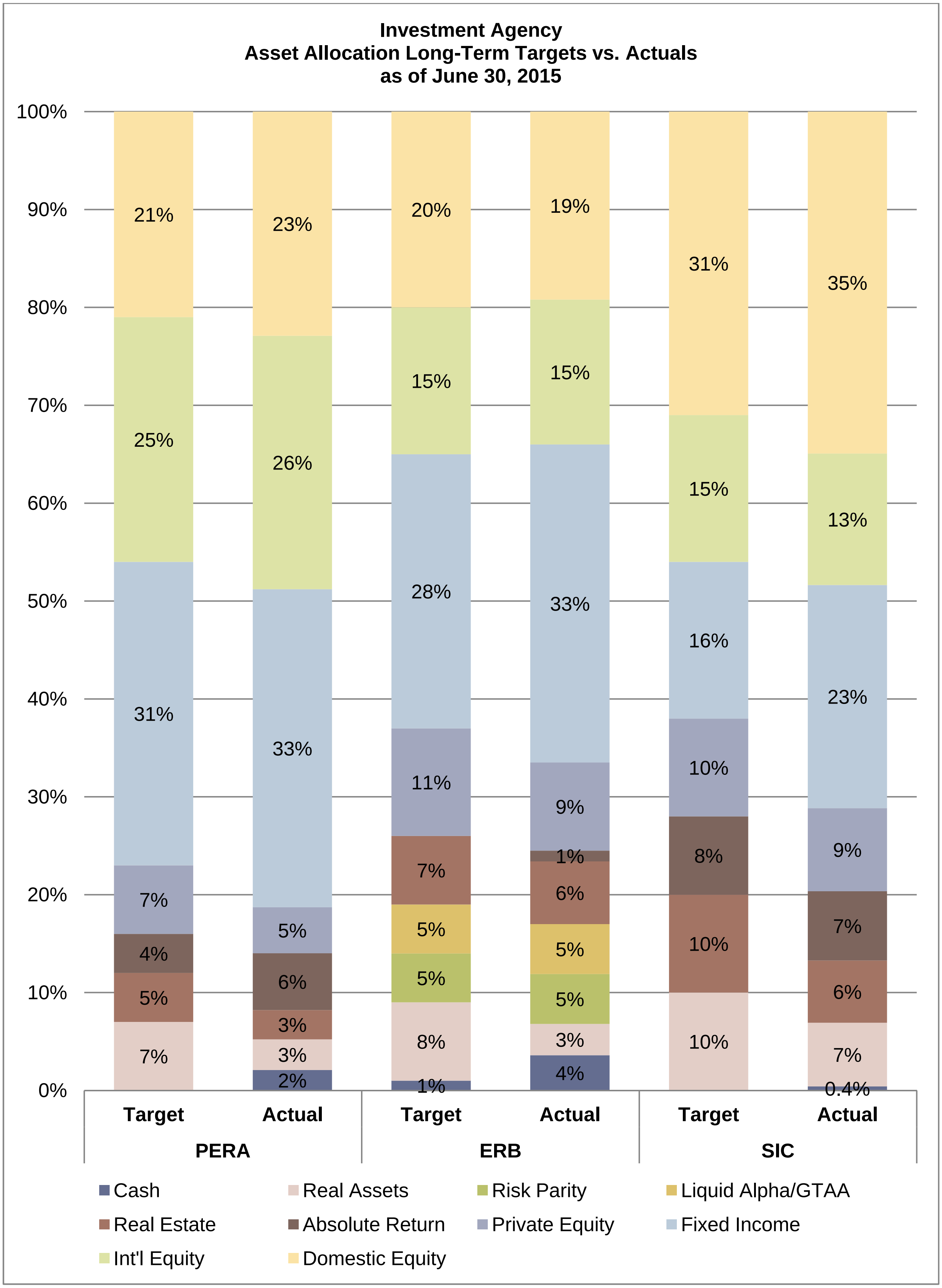
During the second quarter, the return on all four funds fell across a broad range of rankings when compared with other funds in the universe. ERB, LGPF and STPF ranked at the 50th, 36th and 40th percentiles while PERA came in rather poorly at the 82nd percentile. Over the course of the fiscal one-year, ERB outperformed and ranked high in the second quartile, exceeding the ranking of LGPF and STPF which ended in the 40th and 50th percentile respectively, while PERA struggled, ending the year in the 88th percentile.

[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.

Over the three, five and ten-year periods all but one of New Mexico investment funds' rankings among peer funds, fall below the median, with the LGPF's 3-year ranking being highest at 51, and ERB's 10-year ranking being highest, at 48.



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 continue to 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 June 30, 2015
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
21%
25%
31%
7%
4%
5%
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10%
35%
13%
23%
9%
7%
6%
7%
0.4%
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